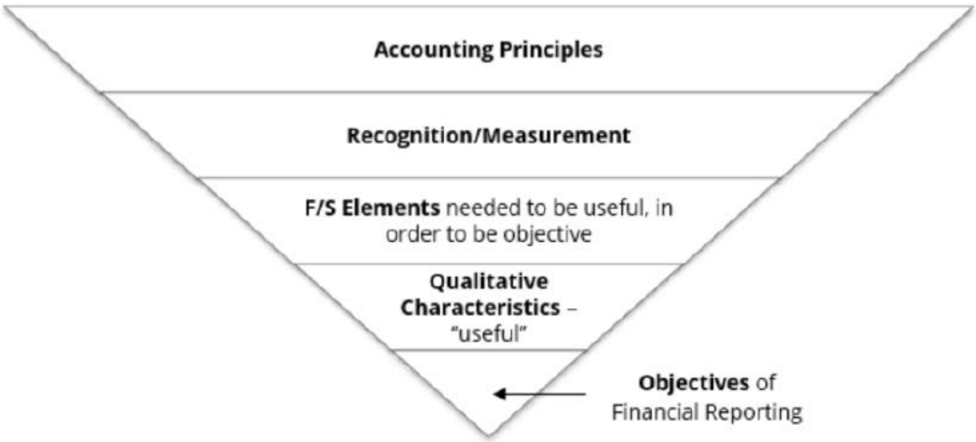
1.02 Elements of Financial Statements



Full Set of Financial Statements

- Statement of Position (Balance sheet)
- Statement of Earnings Financial & Comprehensive Income (Income statement)
- Statement of Cash Flows
- Statement of Changes in Owners' Equity (Statement of Investments by and Distributions to Owners)

10 Key Elements

The F/S elements need to be **useful**. There are 10 key elements that make up all the F/S. The first 3 are the basic elements:

- **Assets** – An economic resource that has a probable future benefit, one can obtain the benefit, and the transaction creating the benefit has already occurred.
- **Liabilities** – An economic obligation in which one needs to use or transfer an asset, it can't be avoided and the transaction has already occurred.
- **Equity or Net Assets** – Assets left over after deducting liabilities. **Equity** consists of 3 elements:
    - Investments by owners (ie, contributions)
    - Distributions to owners (ie, dividends)
    - **Comprehensive Income –** All changes in equity other than "owner" sources. Comprehensive income has 4 elements:
        - **Revenues –** Inflows from an entity's primary operations
        - **Expenses –** Outflows due to an entity's primary operations
        - **Gains** – Increases in equity from incidental transactions

    - **Losses** – Decreases in equity from incidental transactions

Note, however, that comprehensive income is separated into the following two categories on the income statement (discussed further later):

- Net income
- Other Comprehensive Income (DENT[1]):
    - **D**erivative cash flow hedges
    - **E**xcess adjustment of Pension PBO and FV of plan assets at year end
    - **N**et unrealized gains or losses on "available-for-sale" securities
    - **T**ranslation adjustments for foreign currency

When deciding what will be included in income (comprehensive or net income), the capital maintenance concept being used needs to be known.

- **Physical capital maintenance concept** – Only recognize an event when an asset is sold or a liability is settled (measures the effects of price changes in nominal or constant dollars).
- **Financial capital maintenance concept** – Recognize an event as a change in the value of an asset or liability occurs (recognize holding gains and losses – current GAAP).

Current accounting methods emphasize the physical capital approach with fixed assets (not adjusted to market value) but emphasize the financial capital approach with most marketable securities (generally reported at market value). Part of the reason relates to the enhancing qualitative characteristic of verifiability:

- Market values of fixed assets are *difficult to verify* and adjustments based on management estimates are subject to biases.
- The active market for investment securities provides numbers that are *verifiable* and not subject to management bias.

General Accounting Rules & Concepts

Accounting rules and concepts that go along with the key elements:

- **Consistency** – Same principle each year
- **Cost/Benefit** – Costs don't exceed benefits to be derived
- **Matching** – Recognizing a cost as an expense in the same period as the benefit (usually a revenue) is recognized
- **Allocation** – Spreading a cost over more than one period
- **Full Disclosure** – Providing all useful info in the F/S
- **Recognition** – Booking an item in the F/S
- **Realization** – Converting noncash resources into cash or a claim to cash

[1] *Most commonly tested items.*